Weekly Commentary January 29, 2016

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Fed Dovish; GDP Highlights Another Big Productivity Drop

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The Fed statement dominated the week, but today's GDP report deserves attention. I have frequently spoken of the declining productivity, and in Q4 we appear to have suffered another severe productivity collapse. Non-farm payroll in the fourth quarter increased by an extremely healthy 850k (the Household Survey measure increased by almost one million). These numbers are up at nearly a 3% annual pace. Total hours worked in the private sector were up at a 4% rate. Yet the annualized growth of GDP growth was a meager 0.7%, meaning productivity dropped by at least 2% and perhaps 3% or more. For the year, productivity growth will be slightly above zero, an appallingly low number for a year that saw a precipitous drop in the price of energy. Productivity is the source of increases in real wages and improvements in the standard of living. The reasons for the productivity downturn are not clear. Is it measurement error, or has productivity, which has averaged over 2% over the last century, entered a sharp, and perhaps permanent downturn? Economists must focus more resources on this issue.

I interpret Wednesday's Fed statement as very dovish. A key phrase in the December statement, "The Committee judges that …. It is reasonable confident the inflation will rise, over the medium term, to its 2 percent objective," was wrapped in much more cautious language, implying there are many members who are far from confident that inflation is in fact rising to its objective. These doubts will be made more specific in 3 weeks when the minutes are released. The "gradual" language with respect to rate hikes has been maintained, implying that an increase in March is very unlikely.

This morning's move by the BOJ to institute negative interest rates is yet another reason for the Fed to defer raising rates, as the BOJ move may strengthen the dollar, slowing US demand. To boot, this morning's GDP report means that economic growth in 2015 was far below the level the FOMC expected when the Fed raised rates in December. This is the fourth year in a row where GDP growth has fallen well short of Fed estimates.

The next two labor market reports will prove to be an important input in the Fed's March decision. The best news would be if the unemployment rate held stable (or even increased) and job growth was spurred by a rising participation rate. Moderate wage growth is also important especially since productivity trends have been so poor. I shall be flying back from Tokyo when the January labor market number are released, but will report either Friday night or next Saturday morning.
